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Hedging Vs. Cash Contracts

This NebGuide examines the advantages and disadvantages of hedging versus cash contracts.

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There is substantial risk in agricultural production and marketing. Weather, insects, disease, world conditions and other circumstances can affect production and costs.

The actual market price which will exist when the commodity being produced is ready for sale is also unknown. Good management can at least partially compensate for the uncertainty associated with these and other unknowns.

The objective is to discuss two alternatives available to producers for reducing the market gamble or market risk. The alternatives are (1) hedging on the futures market and, (2) selling on forward cash contracts. The latter are also referred to as deferred delivery contracts.

Market risk contains two major parts. These are (1) price risk and (2) market outlet risk. Price risk exists because the producer does not know, until the actual sale of his product, what price he will receive. Uncertainty as to where the producer can market his product is market outlet risk. Under normal conditions market outlet risk is of little concern in Nebraska, but there have been times when it has been quite substantial.

Market risk in agriculture is caused by two conditions. First, there is the time lag between the start and completion of the production cycle. During the production cycle, supply and demand conditions are constantly changing, causing prices to be in a continual state of change. Situations might also develop (transportation problems, labor strikes, elevator closures, etc.), which could eliminate market outlets. If commodities are stored, the risk continues until the date of sale. The nature of the market itself creates the second condition of market risk. Because of the large number of agriculturists producing similar products, they cannot, as individuals, have much influence on the market price. The individual producer has very little market power.

Forward pricing through futures and cash contracts are methods of reducing market risk by entering into a commitment prior to the physical delivery of the commodity to market. Fundamental differences do exist with regard to the procedure followed and the results produced.

When hedging, the producer takes a position in the futures market and commits himself to the terms of the standardized future contract(s) which is (are) sold. While the producer may retain this position and fulfill the requirements of the initial contract, the normal procedure is to buy back the futures contract(s) and sell the commodity on the cash market.

Traditionally the cash contract has consisted of a producer entering into a contract with a specific buyer (local elevator or meat packer). The producer promises to deliver a specified quantity by some future date for an agreed upon price. Since the contract is a legal and binding instrument, the contract sale is generally final and actual delivery is the normal route by which the producer fulfills his commit- ment. Generally a contract will contain some provisions for a financial settlement if the producer is unable to make delivery.

Advantages of Cash Contracts

1. A cash contract allows the seller to fix the price he will receive for his product.
2. By entering into a cash contract with a local buyer, the seller can lock-up a realistic market outlet.
3. A cash contract can be written for any quantity agreed upon by the buyer and seller.
4. In a cash contract there are no margin requirements (cash outlay) by the seller.
5. Cash contracts are relatively easy to understand.

Disadvantages of Cash Contracts

1. Entering into a cash contract reduces marketing flexibility. Normally the only feasible route for fulfillment of a contract is physical delivery of the commodity regardless of which direction the market price has taken.
2. The producer will generally find the cash contract price will be less than the net futures price realized.
3. Sometimes difficulty arises in locating a nearby buyer who wishes to enter into a contract.

Advantages of Hedging

1. Generally the net price received will be higher than the cash contract.
2. The producer has greater marketing flexibility with futures. Because the producer can fulfill his commitment to the futures by simply buying an equal and offsetting contract, the futures market allows the producer to easily adjust to changing conditions. The value of this flexibility arises if, after a hedge position has been taken, there is a substantial price rise. In this situation the producer can buy an offsetting contract and by holding the commodity take advantage of the price rise on the cash commodity market. The producer should be aware that once the hedge is lifted the price protection is lost.
3. In the futures market the producer does not have to locate a specific buyer, therefore, most commonly produced livestock and grains can be readily hedged regardless of where they are produced.
4. Futures contracts can be traded from a few days in the future to nearly a year in advance, allowing the producer a longer period of time to choose a price.

Disadvantages of Hedging

1. When hedging, the producer must deposit margin money with his broker and must meet additional margin calls if the value of the contract he is holding increases (price rise). While this may not affect the final price received it could cause cash flow problems and is an additional marketing

expense.
2. The buyer cannot deal directly with the market, but must deal through a broker.
3. When dealing in futures the producer will find the market much more difficult to understand. In order to obtain a more complete understanding of futures, individual research by the producer is a necessity.
4. The normal procedure for fulfillment of a contract is to buy an offsetting contract. The producer in most cases will find making physical delivery on a futures contract very difficult and expensive. Although this depends on the producers location to a futures contract delivery point.
5. Futures contracts are standardized, and deal in specific quantities. The size of these contracts can present problems.

If the producer wishes to reduce market risk by either cash contracts or hedging in the futures market, he needs to be aware of the advantages and disadvantages of each. Knowing these is still not enough, the producer needs a fuller understanding of each in order to make the best decision for his own individual situation.

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